ISSUES IN THE CLASSIFICATION OF INDIVIDUALS AS EMPLOYEES OR INDEPENDENT CONTRACTORS

A REPORT

PREPARED BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

SUBMITTED TO THE

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

AND THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

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CONTENTS

1

2

3

4

5

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LETTER OF TRANSMITTAL

February 28, 1979.

Honorable AL ULLMAN, *Chairman,*
House Committee on Ways and Means,
Hon. RUSSELL B. LONG, *Chairman,*
Senate Committee on Finance,
U.S. Congress,
Washington, D.C.

DEAR MESSRS. CHAIRMEN: During the conference on the Tax Reform Act of 1976, the House and Senate conferees requested that the staff of the Joint Committee on Taxation undertake a general study of the classification of individuals as employees or independent contractors for Federal income tax withholding, social security (FICA and SECA) and unemployment compensation taxes. The staff's report on its study is transmitted with this letter.

The report on "Issues in the Classification of Individuals as Employees or Independent Contractors" provides an explanation of the present common law rules governing employment status, a description of the source of the controversies in this area, and a review of Congressional action from the original social security legislation through the provisions in the Revenue Act of 1978, which relieved many taxpayers of disputed assessments arising from employment status reclassifications through 1979. The report also discusses the interests and concerns of the parties involved in employment tax controversies and analyses how the present law treats these parties and how several alternative systems would affect them.

At the request of the Joint Committee on Taxation, the General Accounting Office (GAO) conducted a study of the problems involved in employment tax controversies. As part of its study, the GAO developed a legislative proposal. This proposal is examined in detail because its recommendations represent a possible model approach for a statutory solution which has been widely discussed. In addition, the report indicates a number of legal and administrative issues in Federal income tax, social security, and other Federal, State, and local statutes and regulations which are related to, or which may be affected by, legislation on employment tax status standards.

The staff transmits this report to assist Members in developing permanent, substantive legislation for the determination of employment status.

Sincerely yours,

BERNARD M. (BOB) SHAPIRO,
Chief of Staff.

CONTENTS

	Page
Letter of Transmittal	III
I. Background	1
A. Substantive Law and Application	1
1. General	1
2. Differences in tax liabilities	1
a. Employees	1
b. Self-employed individuals	3
3. Information returns	5
B. Origin of Controversies: Increased IRS Enforcement	7
C. Legislative Action	10
1. Original legislation and interpretation	10
2. Tax Reform Act of 1976	11
3. Report by the General Accounting Office	12
4. Revenue Act of 1978: Interim relief	13
II. Analysis	19
A. General	19
B. Taxpayers—Payors	20
C. Individual Workers	22
D. Tax Administrators	23
III. Alternatives	25
A. Present Law	25
1. Uncertainty of classifications	25
2. Noncompliance	27
B. GAO Recommendations	29
1. Analysis of GAO critera	29
2. Comments received on GAO report	32
C. Information Reporting	35
1. Expanded definition	35
2. Lower minimum payment	35
3. Other changes	36
4. Evaluation	36
D. Withholding	38
1. Income tax	38
2. Social Security taxes	39
3. Evaluation	39
E. Statutory Classes of Self-Employed Individuals	41
F. Administration Proposal	43
IV. Related Issues	45
A. Federal Income Tax	45
B. Social Security Taxes	46
C. Other Laws	47

I. BACKGROUND

A. Substantive Law and Application

1. General

With certain limited statutory exceptions,[1] the classification of particular workers as employees or independent contractors (self-employed persons) for purposes of Federal employment taxes has been made under common law rules. The determination of an employer-employee relationship is important because a certain amount of wages paid to employees generally is subject to social security taxes imposed on the employer and the employee under the Federal Insurance Contributions Act (FICA) and unemployment taxes imposed on the employer under the Federal Unemployment Tax Act (FUTA). On the other hand, compensation paid to independent contractors is subject to the tax on self-employment income (SECA). In addition, Federal income tax must be withheld from compensation paid to employees, but payments to independent contractors are not subject to withholding.

Generally, the basis for determining whether a particular worker is an employee or independent contractor has been the common law test of control. Under Treasury regulations, if a person engaging the services of another has "the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which the result is accomplished," the relationship of employer and employee is deemed to exist. On the other hand, the absence of a right to control generally indicates that the person performing the services is an independent contractor. In interpreting the Treasury regulations, twenty factors are used in determining whether workers are employees or independent contractors. (See discussion of Present Law, III.A., p. 25.)

2. Differences in tax liabilities

a. Employees

FICA tax

The Federal Insurance Contributions Act (Code secs. 3101–3126) imposes two taxes on employers and two taxes on employees. These taxes are used to finance the payment of old-age, survivor, and disability insurance benefits payable under Title II of the Social Security Act and to finance the costs of hospital and related post-hospital services incurred by social security beneficiaries as provided in Part A of Title XVIII of the Social Security Act.

[1] Internal Revenue Code section 3121(d)(3) (relating to statutory employees under the Federal Insurance Contributions Act) establishes four categories of statutory employees: certain agent-drivers or commission-drivers: full-time life insurance salesmen: home workers performing services on goods or materials; and full-time traveling or city salesmen. See also, Code secs. 3306(i) and 1402(d).

The employee's share of FICA taxes is measured by the amount of wages received with respect to employment. The term "wages" generally means pay received by an employee for employment covered by the Social Security Act, unless the pay is excluded specifically by law (Treas. Reg. § 31.3121 (a)–1). The term "employment" includes all nonexempt service, of whatever nature, performed by an employee for the person employing him or her (Treas. Reg. § 31.3121(b)–3). Employers withhold the employee's share of FICA taxes from each of their employees' wages when paid (Code secs. 3102 (a) and (b)).

The FICA tax rates are scheduled to increase in future years, as indicated in the following table:

Scheduled Increases in FICA Tax Rates

Calendar Year	*Social Security Rate*	*Hospital Insurance Rate*	*Total FICA Rate*
1978	5.05%	1.00%	6.05%
1979–80	5.08	1.05	6.13
1981	5.35	1.30	6.65
1982–84	5.40	1.30	6.70
1985	5.70	1.35	7.05
1986–89	5.70	1.45	7.15
1990	6.20	1.45	7.65

In addition to the FICA tax rate increases, the following wage base increases are scheduled to take effect under present law:

Calendar Year	*Wage base*
1978	$17,700
1979	22,900
1980	25,900
1981	29,700

For calendar year 1978, both employers and employees were required to pay FICA taxes of 6.05 percent each on the first $17,700 of the employee's wages, for a maximum of $1,070.85 each. As a result of the increases in the FICA rate and wage base, the maximum amount payable for both an employer and an employee will be $1,403.77 each in calendar year 1979; $1,587.67 each in calendar year 1980; and $1,975.05 each in calendar year 1981.

FUTA tax

The Federal Unemployment Tax Act (Code secs. 3301–3311) imposes a tax on employers. FUTA tax revenues are used to pay all of

the administrative costs of the Federal and State unemployment compensation programs and to help finance the payment of benefits to unemployed insured workers. The FUTA tax is levied on covered employers at a current rate of 3.4 percent on wages of up to $6,000 a year paid to an employee (Code sec. 3301). However, a 2.7 percent credit against Federal tax liability is provided to employers who pay State taxes under an approved State unemployment compensation program (Code sec. 3302). For employers in States which have an approved unemployment compensation program, the effective FUTA tax rate is 0.7 percent.

The FUTA tax generally applies to employers who employ one or more employees in covered employment for at least 20 weeks in the current or preceding calendar year or who pay wages of $1,500 or more during any calendar quarter of the current or preceding calendar year. In addition, certain agricultural labor and domestic services constitute covered employment for purposes of the FUTA tax.

Income tax withholding

In addition to the responsibility for FICA and FUTA taxes, an employer who pays wages to individual employees (or who has employees who report tips) must withhold a portion of the wages to satisfy all, or part of, the employee's Federal income tax (Code sec. 3402). The definitions relating to employment for purposes of withholding are similar to the FICA and FUTA definitions. The term "employer" is defined as any person or organization for whom an individual performs any service as an employee. An "employee" is any individual who performs services subject to the control of an employer, both as to what shall be done and how (Treas. Reg. § 31.3401(c)–1). The term "wages" is defined generally as all remuneration, unless specifically excluded, for services performed by an employee for his or her employer, including the cash value of all remuneration paid in any medium other than cash (Code sec. 3401(a)).

FUTA taxes and the employer's share of FICA taxes generally are deductible by the employer for income tax purposes as ordinary and necessary business expenses. The employee's share of FICA taxes is not deductible by the employee.

b. Self-employed individuals

The Self-Employment Contributions Act (Code secs. 1401–1403) imposes two taxes on the self-employed. The SECA taxes finance the cost of old-age, survivors, and disability insurance benefits payable under Title II of the Social Security Act and the cost of hospital and related post-hospital services incurred by social security beneficiaries as provided for in Part A of Title XVIII of the Social Security Act.

The taxes levied under SECA, and the amount of income which may be credited toward old-age, survivors, and disability insurance benefits or hospital insurance coverage, are based on an individual's self-employment income. The term "net earnings from self-employment" means the sum of: (1) the gross income derived by an individual from

any trade or business carried on by such individual, less allowable deductions attributable to such trade or business, and (2) the individual's distributive share (whether or not distributed) of the ordinary net income or loss from any trade or business carried on by a partnership of which the individual is a member.

This general definition, however, is subject to the exclusion of certain trades or businesses,[1] and to certain special rules for computing gross income or the distributive share of partnership ordinary net income or loss. The term "self-employment income" excludes net earnings from self-employment in any taxable year if such earnings are less than $400.

The old-age, survivors, and disability insurance tax rate under SECA is higher than the rate applicable to an employer or employee (under FICA). SECA hospital insurance rate is the same as the employer-employee hospital insurance rate. However, the combined employer-employee FICA rate, that is the total tax with respect to one employee, is higher than the SECA rate.[2]

For calendar year 1978, self-employed individuals with annual net self-employment earnings of $400 or more were required to pay a SECA tax of 8.10 percent on self-employment earnings up to $17,700, for a maximum SECA tax of $1,433.70. For calendar year 1979, self-employed individuals must pay a tax of 8.10 percent on self-employment earnings up to $22,900, for a maximum SECA tax of $1,854.90. (For calendar year 1978, the maximum, combined employer-employee FICA tax was $2,141.70; for 1979, it is $2,807.54.) The following table shows the schedule increases in the SECA tax rate for calendar years 1978 through 1990:

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[1] The term "trade or business," with certain exceptions, has the same meaning when used with reference to self-employment income or net earnings from self-employment as when used in section 162 of the Code, relating to trade or business expenses for income tax purposes.

[2] A rationale for setting the SECA rate at 150 percent of the FICA employee rate was stated by the Advisory Council on Social Security in its "Recommendations for Social Security Legislation" reported to the Senate Committee on Finance, Doc. No. 208, 80th Cong. 2d Sess., 1949. In recommending that self-employed individuals be brought into the social security system, the Council recommended the lower overall self-employment contribution rate for two reasons. First, the Council believed that self-employment earnings are derived partly from personal services and partly from capital investment. The difference in the rates reflected an attempt to exempt from the SECA tax income from capital. Second, it was thought that if the self-employed were required to pay twice the employee rate (that is, the total, combined employer-employee FICA rate), they would be "overcharged" for their coverage in relation to what they would have to pay for similar protection under private insurance.

In 1965, the Advisory Council on Social Security concluded that the difference between the SECA rate and the combined employer and employee FICA rate was not justified. The Council recommended gradually increasing the SECA rate, but not above the the cost of providing benefits for the self-employed. Report of the Advisory Council on Social Security, January 1, 1965.

Scheduled Increases in SECA Tax Rates

Calendar Year	*Social Security Rate*	*Hospital Insurance Rate*	*Total SECA Rate*
1978	7.10%	1.00%	8.10%
1979–80	7.05	1.05	8.10
1981	8.00	1.30	9.30
1982–84	8.05	1.30	9.35
1985	8.55	1.35	9.90
1986–89	8.55	1.45	10.00
1990	9.30	1.45	10.75

Generally, the same ceiling on the earnings base subject to FICA tax also applies to net earnings from self-employment which are subject to SECA tax. However, special rules apply to self-employed persons who report income on a fiscal year basis.

While there is no Federal income tax withholding with respect to self-employment income, a self-employed individual may be required to file a declaration of estimated income tax if his or her gross income for the taxable year reasonably can be expected to include more than $500 from sources other than wages (Code sec. 6015). However, no such declaration is required if the amount of estimated tax for the year reasonably can be expected to be less than $100. Also, each individual (other than a nonresident alien individual) with $400 or more of net earnings from self-employment for the taxable year must file a return showing the self-employment tax due (Code sec. 6017).

3. Information returns

Under present law, persons engaged in a trade or business (including activities which are not for the purpose of gain or profit) generally must file information returns with respect to certain payments of $600 or more in any taxable year (Code sec. 6041(a)).[3] This reporting obligation, subject to various exceptions, applies to payments (regardless of whether made in cash or property) of salaries, wages, commis-

[3] Generally, these returns are intended to inform the Internal Revenue Service that specified items have been disbursed by a payor. This information may aid the Service in determining whether the recipient of the item covered by the return has treated it properly for tax purposes. The obligation to file information returns is in addition to the requirement to file returns which reflect the filer's primary liability for the payment of a tax.

sions, fees, other forms of compensation for services, and other fixed or determinable gains, profits, or income.[4]

These information returns, which are required to be filed on an annual basis, generally must contain the name, address, and tax identification number of the recipient of the payment (Code secs. 6041 (a) and (d), and 6109(a)). Recipients covered by this reporting requirement must furnish their name and address to the payor (Code sec. 6041 (d)). However, there is no requirement that the payor furnish the recipient with a copy of the return, as is the case for some other returns (see, e.g., Code sec. 6049(c) with respect to information returns of certain interest payments).

Because these returns must be filed on an annual basis, payors must keep track of the cumulative amount paid to any individual during the year to determine if they have a filing obligation. The records necessary to satisfy this requirement generally must be maintained for tax deduction purposes in any event.

A $1 penalty is provided for each failure to file an information return (Code sec. 6652(b)). The maximum aggregate penalty per taxpayer for all such failures during any calendar year is $1,000.

Generally, amounts paid to employees, regardless of whether they are subject to withholding, are not reportable on the usual information return (Form 1099). Instead, such amounts are reportable on information returns (Form W–2) which relate especially to payments to employees.

The Internal Revenue Service's Information Returns Program (IRP) matches the information returns filed with respect to payments to some individuals with their income tax returns to detect non-filing or under-reporting of income. Under this program, all information returns filed for individuals on magnetic tape, and some of those filed on paper forms (approximately 10 to 15 percent) are matched. During 1977, the Service received almost 470 million information returns from businesses and organizations required to report payments of wages, interest, and dividends; over 245 million of these returns were submitted on magnetic tape.[5]

Approximately 2 percent of all information returns [6] filed relate to compensatory payments of $600 or more during the year. However, most of these payments represent rents, royalties, and similar items rather than compensatory payments. It appears that the majority of information returns which relate to compensatory payments are submitted to the Service on paper forms, rather than magnetic tape.

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[4] For information return purposes, income is deemed to be "fixed" when it is to be paid in definite, predetermined amounts. Income is considered to be "determinable" if there is a method by which the amount to be paid may be calculated, regardless of whether the income is payable at regular intervals, or whether the amount to be paid may fluctuate in accordance with the occurrence of an event, e.g., commissions payable on the sale of merchandise. In addition, an amount is considered to have been paid when it is credited or set aside for another without substantial limitations or restrictions as to the time or manner of payment, and is made available so that it may be brought within the payee's control and disposition at any time.

[5] Annual Report of the Commissioner of Internal Revenue, 1977, 8–19 (1978).

[6] Payments of $600 or more for which information returns are required are listed in sec. 6041(a).

B. Origin of Controversies: Increased IRS Enforcement

In the late 1960's, the IRS increased its enforcement of the employment tax laws. Previously, employment tax audits had been superficial or sporadic and only occasionally entailed examination of employment status issues. Many controversies developed between taxpayers and the Service about whether individuals treated as independent contractors should be reclassified as employees. If the IRS prevailed on a reclassification, the taxpayer became liable for employment taxes—withholding, social security, unemployment—which neither had been withheld nor paid to the Treasury.

The retroactive reclassification of independent contractors as employees by the Internal Revenue Service could give rise to four general types of problems: (1) taxpayers whose workers were reclassified as employees could be assessed employment taxes retroactively for years not subject to the statute of limitations; (2) double taxation could occur if the taxpayers paid withholding assessments for the same liabilities for which workers had paid income tax; (3) overpayments of social security taxes could occur if taxpayers paid FICA taxes with respect to workers who had paid SECA taxes; and (4) retirement plans could be disqualified.

When the IRS reclassified a worker, previously treated as an independent contractor, as an employee, the person who was found to be the employer generally was held responsible for all employment tax liabilities (income tax withholding and both the employer's and the employee's share of social security taxes) with respect to the individual who was reclassified as an employee. The IRS generally would adjust Federal income tax withholding assessments if the employer was able to furnish certificates signed by his or her workers showing that the workers had paid their proper amount of income tax (Code sec. 3402(d)). Thus, the burden was on the employer to prove that the individuals who had been reclassified as employees had paid their income taxes. In situations where there were only a few workers, and the workers still lived in the employer's vicinity, and had maintained adequate records and were cooperative, this proof was not difficult. However, in situations where there were many workers, a high turnover rate, or the workers maintained inadequate records or were uncooperative, obtaining this proof could be very difficult and expensive.

Unlike the income tax withholding liability, the reclassified employee's share of FICA tax generally was not abated by the IRS by the amount of SECA tax already paid on the same income. Present law (Code sec. 6521(a)) authorizes a FICA-SECA offset only if the employee is prevented by law from filing for a refund of the SECA tax paid in error. This rule may result in the double collection of the employee's portion of social security tax: (1) once from the employer

as the FICA tax he or she initially failed to withhold from the reclassified employee, and (2) once from the employee as the SECA tax previously paid in error. The employer's portion of the FICA tax assessment does not represent a double payment because that portion of the tax was not paid previously if workers were not treated as employees; it is paid for the first time after reclassification of such workers.

The reclassification of a worker as an employee also may have adverse effects on self-employed (H.R. 10) retirement plans. If the individual previously had received a determination from the IRS that he or she was an independent contractor and then was reclassified as an employee, the retirement plan would be frozen and any future contributions to the plan would not be exempt from tax. If the individual previously had not received such a determination, the plan would be disqualified and all amounts in the plan (previous contributions plus income) would be taxable. Furthermore, if an employer previously had established a qualified retirement plan for some workers whose status as employees was recognized, and the IRS subsequently reclassified as employees additional workers whom the employer had been treating as independent contractors, the previously qualified retirement plan for the employees could be disqualified for failure to meet the minimum "coverage" requirements (Code sec. 410(b)).

Many taxpayers complained that proposed reclassifications involved a change of position by the Internal Revenue Service in interpreting how the common law rules applied to their workers or industry. Some taxpayers had prior private letter rulings or technical advice memoranda from the Service in which the Service held that the workers were independent contractors. Others pointed to prior audits in which their treatment of workers as independent contractors was not challenged. Before the 1970's, however, most audits did not focus on employment tax status determinations; so most taxpayers relied on their own judgment, industry practice, or, in a few industries, published revenue rulings.

During the last few years, the IRS published pairs or groups of revenue rulings which contained one or more restatements of earlier rulings determining workers to be independent contractors and other rulings determining that workers in the same general industry, but under somewhat different circumstances, were employees. Taxpayers have pointed to these so-called "bracketed rulings" as evidence of changes in IRS positions. (The Internal Revenue Service generally has viewed these rulings as distinguishing prior rulings or as interpreting new or changed relationships.)

Upon an assessment of an employment tax, the only judicial remedy which ordinarily is available to a taxpayer is the payment of the tax followed by a refund suit in a district court.[1] However, employment taxes are divisible taxes, *i.e.*, they are predicated upon the employment of an individual for a quarter. Therefore, a taxpayer may challenge an assessment, due to a reclassification of workers incident to an audit or otherwise, by paying the tax for one worker for one quarter, and then suing for a refund of that tax.[2] Generally, such a refund suit also would

[1] Because the Tax Court lacks jurisdiction over employment taxes, a suit cannot be commenced without paying the tax.

[2] See, e.g., *Marvel v. U.S.*, 548 F.2d 295 (10th Cir. 1977).

include a claim for an abatement of the unpaid, but previously assessed, taxes. In practice, the Service ordinarily then will counterclaim for the balance of the assessment.

This procedure allows a resolution of the employment status issues without necessitating that the full amount of the assessment be paid prior to litigation. However, many taxpayers have found such litigation an unsatisfactory method of resolving employment tax disputes. This results in part from the costs and time involved in both the judicial and administrative phases of the resolution of the issue. In addition, some taxpayers point to the fact that there is no assurance that the Service will refrain from levying on the taxpayer's property during the pendency of the litigation,[3] and to the fact that the litigation itself creates a contingent liability which ordinarily must be noted for financial statement purposes.

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[3] In partial payment litigation, the Service is not precluded by section 6213 from levying against a taxpayer's property. However, in most situations there is little likelihood of a unilateral seizure by the Service in the absence of circumstances which might jeopardize the availability of the taxpayer's funds subsequent to the litigation. See *Marvel v. U.S.*, 548 F.2d 259 ,39 AFTR2d 679, 680 n. 1 (10th Cir. 1977) ; Internal Revenue Manual, Supp. 5547.

C. Legislative Action

1. Original legislation and interpretation

Although Congress specifically has classified certain occupational categories of individuals as either employees (sec. 3121(d)(3)) or independent contractors, it generally has maintained the use of the common law control test for determining employment status.

The original employment tax provisions, which were contained in the Social Security Act of 1935, defined the term "employee" to include a corporate officer. The Treasury Regulations promulgated in 1936 under this Act defined the term "employee" in the same manner as it is defined in the present regulations pertaining to the common law test.

In 1939, the Social Security Board proposed to expand the definition of the term "employee" to include "more of the persons who furnish primarily personal services," such as various salespersons.[1] The Board explained that these individuals were "for all practical purposes employees," notwithstanding the fact that they might be classified otherwise under common law. In H.R. 6635, the House of Representatives adopted this definition both for Social Security benefit purposes and for FICA tax purposes.[2] However, it rejected it for FUTA purposes. Thus, the House would have based the classification of an individual "as an employee" on the "economic reality" and the appearance of the relationship between an individual and a business.

The House definition contained in H.R. 6635, however, was rejected by the Senate,[3] which believed it to be "inexpedient to change the existing law which limits coverage to employees." The Senate version of the bill was adopted in conference,[4] and thus, the original definition remains in present law.

The original income tax withholding provisions, which were enacted as part of the Current Tax Payment Act of 1943, adopted a definition of "employee" which was virtually identical to the present definition in section 3401(c) of the Code. This definition was based on the Victory Tax withholding provisions, which had been added to the Internal Revenue Code of 1939 by section 172 of the Revenue Act of 1942. The Victory Tax and the Current Tax Payment Act embodied the Congressional decision that the principal test for the determination of employment status should be the common law master-

[1] Hearings before the House Committee on Ways & Means Relative to the Social Security Act Amendments of 1939, 76th Cong., 1st Sess. 8, 11, 61–62, 64 (1939).

[2] H.R. 6635, 76th Cong., 1st Sess. secs. 606, 801 (1939); H.R. Rep. No. 728, 76th Cong., 1st Sess. 61–62, 76–77 (1939).

[3] H.R. 6635, 76th Cong., 1st Sess. secs. 606, 801 (1939). S. Rep. No. 734, 76th Cong., 1st Sess. 75, 88 (1939).

[4] H.R. Rep. No. 1461, 76th Cong., 1st Sess. 14, 18 (1939).

servant relationship. Under this test, a common law employer-employee relationship was to exist if the person for whom the services were to be performed had the right to exercise control over the result desired to be accomplished, as well as the manner in which it was effectuated. Thus, both the Victory Tax and the Current Tax Payment Act excluded from the definition of an employee, individuals who would not be classified as such under the common law concept of master and servant. This decision, in turn, was embodied in the Treasury Regulations issued under these Acts. Those regulations are essentially identical to the present employment tax regulations.

In 1947, the Supreme Court decided several cases in which it applied an "economic reality" test in the determination of the employment tax status of certain individuals.[5] Following these decisions, the Treasury Department issued proposed regulations which would have replaced the common law control test for the determination of whether an individual is an "employee" for FICA and FUTA purposes with an "economic reality" test.[6] Under the proposed regulations, the existence and degree of the right of control over the performance of services by an individual would have been one of six factors to be used for the determination of an individual's employment status. The crux of the test in the proposed regulations would have been an individual's economic dependence upon the business in connection with which services were rendered.

In response to the 1947 Supreme Court decisions, and the proposed Treasury Regulations, the Congress passed the "Gearhart" Resolution of 1948.[7] This resolution expressed the Congressional intent that the term "employee" should continue to be defined for FICA and FUTA purposes with regard to the status quo, and not pursuant to an "economic reality" test. Thus, under the "Gearhart" Resolution, Congress expressed its intent to exclude from the definition of "employee" any individual who occupied the status of an independent contractor under the common law regulations and to exclude any individual who was not an "employee" under those regulations from the term "employee for FICA and FUTA purposes." The Gearhart Resolution was passed over President Truman's veto.

The House Report accompanying the Gearhart Resolution rejected the "economic reality" test of the Supreme Court's decisions, but the Senate Report reconciled the rationale of those decisions with the common law regulations. The Senate report explained that the "economic reality" factors applied by the Court were relevant to the common law test because they were interwoven with the "end-point determination of whether . . . common law control" existed.

2. Tax Reform Act of 1976

The House and Senate conferees on the Tax Reform Act of 1976 included in the Statement of Managers a request that until the completion of a study by the staff of the Joint Committee on Taxation on the problems of classifying persons as employees or independent

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[5] See *U.S.* v. *Silk*, 331 U.S. 704 (1947); *Harrison* v. *Greyvan Lines Inc.*, 331 U.S. 704 (1947); *Bartels* v. *Birmingham*, 332 U.S. 126 (1947).

[6] 12 F.R. 7966–7969 (1947).

[7] P.L. No. 80–642. H.J. Res. 296, 80th Cong., 2d Sess. (1948).

contractors,[8] the Internal Revenue Service "not apply any changed position or any newly stated position in this general subject area to past, as opposed to future taxable years." The Joint Committee on Taxation had previously asked the General Accounting Office (GAO) to examine the Internal Revenue Service's administration of employment taxes, including the classification of individuals as either self-employed individuals or as employees.

3. Report by the General Accounting Office

The GAO report[9] indicated that the principal problem with regard to the classification of individuals for employment tax purposes is the uncertainty in the interpretation and application of the governing common law rules. In its report, the GAO noted that this uncertainty has created difficulty for individuals, employers, tax practitioners, and tax administrators. After surveying a broad range of industries and workers, the GAO concluded that uncertainty and controversies most frequently arise in cases in which an individual operates a business which is separate from, or subordinate to, another business which the Internal Revenue Service may consider to be the individual's employer.

The GAO did not believe such a relationship should always be considered one of employer-employee but should in some cases be treated as a self-employment situation involving an independent contractor. The GAO report includes both legislative and administrative recommendations for establishing specific criteria for classification purposes and for instituting procedures for alleviating possible double taxation in reclassification cases.

Classification proposal

The GAO specifically recommended that the Congress amend section 3121 of the Code to exclude the owner of a separate business entity from the common law definition of employee in those instances where he or she meets all the following requirements:

(1) has a separate set of books and records which reflect items of income and expenses of the trade or business;

(2) has the risk of suffering a loss and the opportunity of making a profit;

(3) has a principal place of business other than at a place of business furnished by the persons for whom he or she performs or furnishes services; and

(4) holds himself or herself out in his or her own name as self-employed and/or makes his or her services generally available to the public.

The GAO noted that in some situations a worker may meet some, but not all, of the four criteria and still have a valid basis for being classified as self-employed. In such circumstances, the GAO believes that some type of common law criteria should be applied, but only if there is evidence that the worker is a self-employed individual. To deal with such cases, the GAO recommended that the Congress amend

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[8] H.R. Rep. No. 94-1515, 94th Cong., 2d sess. 489 (1976).

[9] Report of the Comptroller General to the Joint Committee on Taxation, "Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions," GGD-77-88, November 21, 1977.

section 3121 of the Code to require that separate business entities meet three of the four criteria before using common law criteria to determine employment status. The GAO recommended that workers be considered employees if they cannot meet at least three of the proposed criteria.

Limitation on reclassifications

The GAO further recommended that the Code be amended to prohibit the IRS from retroactively reclassifying workers as employees, except in cases involving fraud, where a business: (1) obtained annually from the persons whom the business classified as self-employed signed certificates stating that these persons meet all four of the separate business entity criteria, described above; and (2) annually provided the IRS the name and the employer identification or social security number of all such certificate signers. The GAO further proposed that the certificate should be signed by the contractor under penalty of perjury, in a form approved by the Secretary of the Treasury.

In order to alleviate the problem of double collection of social security taxes on the same income, the GAO recommended that the Congress amend section 6521 of the Code to authorize the IRS to reduce the employees' portion of FICA taxes assessed against employers by an appropriate portion of the self-employment taxes (SECA) paid by reclassified workers for the open statute years.

4. Revenue Act of 1978: interim relief

The Revenue Act of 1978[10] provides interim relief for taxpayers who are involved in employment tax status controversies with the Internal Revenue Service, and who potentially face large assessments, as a result of the Service's proposed reclassifications of workers, until 1980 to give the Congress adequate time to resolve the many complex issues involved in this area.

General

The Revenue Act of 1978 provides an interim solution for controversies between the Internal Revenue Service and taxpayers involving whether certain individuals are employees by—

(1) terminating certain employment tax liabilities for periods ending before January 1, 1979,

(2) allowing taxpayers, who had a reasonable basis for not treating workers as employees in the past, to continue such treatment for periods ending before January 1, 1980, while the Congress works on a comprehensive solution, without incurring employment tax liabilities, and

(3) prohibiting the issuance of Treasury regulations and Revenue Rulings on common law employment status before 1980.

Termination of certain pre-1979 employment tax liability

The Act provides relief from employment tax liability to certain taxpayers involved in employment tax status controversies with the

[10] P.L. 95–600, H.R. 13511, sec. 530. This matter was also the subject of a similar, separately reported bill in the 95th Congress, H.R. 14159, which was reported by the House Ways and Means Committee (H.R. Rep. 95–1748, Oct. 10, 1978). The provisions adopted in the Revenue Act of 1978 were based on a Senate amendment, which followed S. 3007, a Senate bill, as well as H.R. 14159.

Internal Revenue Service as a result of the Service's proposed reclassifications of workers, whom taxpayers have considered as having independent contractor status or some other status (e.g., customer), as employees. For purposes of determining such taxpayers' employment tax liabilities, the Act provides that workers shall be deemed not to be the taxpayers' employees, unless the taxpayers had no reasonable basis for not treating the workers as employees.

Liabilities terminated under the Act are those for Federal income tax withholding, Social Security (FICA), and unemployment (FUTA) taxes for any period ending before January 1, 1979, during which the taxpayers did not treat the workers as employees.

It is not necessary that a taxpayer have treated workers other than as employees for all pre-1979 periods in order to qualify for relief. A taxpayer who treated workers as employees for some pre-1979 periods, may obtain relief for other pre-1979 periods when they were treated other than as employees, provided there was a reasonable basis for such treatment. (However, an anti-abuse rule, discussed later, denies relief for periods during 1979, if the taxpayers' treatment of workers other than as employees is inconsistent with the treatment of such workers for any period beginning after December 31, 1977.)

Generally, the Act terminates pre-1979 employment tax liabilities of taxpayers who had a reasonable basis for treating workers other than as employees. The Congress intended that this reasonable basis requirement be construed liberally in favor of taxpayers. In addition, the Act establishes several alternative statutory standards which constitute "safe havens," and thus, when met, qualify a taxpayer for the termination of employment tax liability.

The first statutory reasonable basis standard is met if a taxpayer's treatment of an individual as not being an employee for a period was due to reasonable reliance on judicial precedent, published rulings, technical advice with respect to the taxpayer, or a private ruling, for example, a "letter ruling," or a "determination letter," issued to the taxpayer. Under this test, the precedent or published ruling upon which a taxpayer reasonably relied does not have to relate, necessarily, to the particular industry or business in which the taxpayer is engaged.

Under the second statutory "safe haven" standard, a taxpayer is treated as satisfying the reasonable basis test for the treatment of an individual as other than an employee for employment tax purposes, by showing reasonable reliance on a past Internal Revenue Service audit of the taxpayer. Such an audit need not have been for employment tax purposes. However, a prior audit would qualify as a "safe haven" basis for a taxpayer's reliance only if the audit entailed no assessment attributable to the taxpayer's treatment (for employment tax purposes) of individuals holding positions substantially similar to the position held by the individual whose treatment is at issue. However, a taxpayer does not meet this second test if in the conduct of a prior audit an assessment attributable to the taxpayer's treatment of an individual was offset by other claims asserted by the taxpayer.

The third statutory method for a taxpayer to establish a reasonable basis for the treatment of an individual as other than an employee is to show that such treatment coincided with a long-standing, recognized

practice of a significant segment of the industry in which the individual whose status is at issue was engaged. This test does not require that a practice be uniform throughout an entire industry.

The three statutory methods for fulfilling the requirement that a taxpayer had a reasonable basis for the treatment of an individual as other than an employee are not the exclusive ways of meeting the Act's reasonable basis requirement. A taxpayer who can demonstrate a reasonable basis for the treatment of an individual in some other manner also is entitled to termination of employment tax liabilities.

Termination of employment tax liabilities under the Act is made available to taxpayers who are under audit by the Internal Revenue Service or who are involved in administrative or judicial proceedings with respect to assessments based on employment status reclassifications. Relief also is extended to any claim for a refund or for a credit of any overpayment of an employment tax resulting from the proposal's termination of liability, provided the claim is not barred on the Act's date of enactment by any law or rule of law.

Taxpayers who have entered into final closing agreements under section 7121 or compromises under section 7122 with respect to employment status controversies are ineligible for relief under the Act, unless they have not completely paid their liability. Thus, for example, a taxpayer who has agreed to or compromised a liability for an amount which is to be paid in installments, but who still has one or more installments to pay, is relieved of liability for such outstanding installments. Taxpayers who settled employment status controversies administratively with the Internal Revenue Service or who unsuccessfully litigated such cases are eligible for relief, provided their claims are not barred by the statute of limitations or by the application of the doctrine of *res judicata*. However, an unsuccessful litigant in an employment status case, who fulfills the Act's requirements, can avoid collection of any unpaid employment tax liabilities, regardless of the doctrine of *res judicata*.

Eligibility for relief for pre-1979 periods is to be determined independently of a taxpayer's eligibility for relief for any periods in 1979. With respect to pre-1979 periods, there is no requirement that the taxpayer have filed all Federal tax returns (including information returns), required to be filed with respect to an individual whose status is at issue, on a basis consistent with the taxpayer's treatment of such individual as not being an employee.

Employment tax liability for 1979

Until the Congress enacts legislation clarifying the employment tax status of individuals, taxpayers will remain uncertain about the proper treatment of many workers. Therefore, the Act allows taxpayers to continue to treat workers as other than employees through 1979, unless the taxpayers have no reasonable basis for not treating the workers as employees. However, in order to qualify for relief for 1979, the Act also provides that taxpayers must file all Federal tax returns (including information returns) required to be filed for periods after December 31, 1978, with respect to workers whose status is at issue, on a basis consistent with the taxpayers' treatment of the workers other than as employees. Thus, the Act prospectively relieves taxpayers of liabilities which they might incur during 1979. The Con-

gress intends to work on formulating comprehensive legislation on the employment tax status controversy during this period.

Except for the filing requirement, taxpayers' eligibility for the prospective relief from 1979 liabilities is determined under the same tests and the same liberal interpretations of the tests which determine eligibility for pre-1979 relief.

It is expected that legislation developed during 1979 to clarify the employment tax status of individuals would become effective on the earlier of January 1, 1980, or the date of enactment, and would replace present law for all periods thereafter.

Anti-abuse provision

To prevent taxpayers from changing the way they treat workers for employment tax purposes solely to take advantage of the relief provisions, the Act denies relief in such circumstances. The Act prohibits the termination of any potential employment tax liability with respect to the treatment of any individual for employment tax purposes for any period ending after December 31, 1978, and before January 1, 1980, if the taxpayer (or a predecessor) has treated an individual holding a substantially similiar position as an employee for any period beginning after December 31, 1977. The application of this provision to taxpayers and their predecessors is intended to prevent avoidance of this rule, for example, by reincorporations.

Refunds or credits of overpayments

The Act allows taxpayers at least a one-year period for filing claims for refunds or credits attributable to the relief provided in the Act. If a taxpayer's claim for refund or credit is not barred on the Act's date of enactment by any law or rule of law, the taxpayer has at least until November 6, 1979, that is, the date one year after the Act's date of enactment, for filing a claim. If the taxpayer is entitled to a longer period under the general statute of limitations for filing such claims, the longer period applies.

Generally, taxpayers should file refund or credit claims asserting grounds for relief under the Act with the Internal Revenue Service. If the taxpayer already has an open claim filed with the Service, or is involved in litigation over such a claim with the Department of Justice, the original claim will qualify as a claim for relief under this provision, provided the taxpayer notifies either the Service or the Department of Justice, whichever is appropriate, within the proper time period, of the taxpayer's basis for relying on the Act for relief.

Penalties and interest

If a taxpayer is relieved of liability for any tax under the provision contained in the Revenue Act, any liability for interest or penalties attributable to such tax liability is forgiven automatically. This relief applies to all such interest and penalties for both pre-1979 and 1979 liabilities, whether charged directly against the taxpayer or personally against the taxpayer's officers.

Workers' status, liabilities and rights

The Act does not change in any way the status, liabilities and rights of an individual whose employment status is at issue.

Prohibition against IRS Revenue Rulings and Regulations

The Act also prohibits the Department of the Treasury (including the Internal Revenue Service) from publishing any regulation or Revenue Ruling classifying individuals for purposes of employment taxes under interpretations of the common law. This prohibition became effective November 6, 1978 the date of enactment of the Act, and remains in effect until January 1, 1980, or, if earlier, the effective date of any law subsequently enacted to clarify the employment status of individuals for purposes of employment taxes.

The prohibition applies to Revenue Rulings having precedential status but does not apply to the issuance of private letter rulings requested by taxpayers. The prohibition does not extend to regulations or Revenue Rulings based on statutory provisions dealing with the employment tax status of particular workers, such as certain fishermen, which do not involve the application of common law standards; nor does the prohibition apply to the determination of matters such as effective dates, which do not entail issues of common law employment status for purposes of employment taxes.

This provision was effective upon enactment (November 6, 1978).

II. ANALYSIS

A. General

The controversies over the proper classification of workers for employment tax purposes involve at least three parties: the taxpayers who pay workers for their services; the individual workers who perform the services; and the tax administrators who review the taxpayers' classification of workers. Each of these parties has a significant interest in establishing correct classifications because the classifications affect their respective responsibilities and liabilities. Moreover, the concerns of these parties may not only vary, but even may conflict. If the interpretation of the present law governing employment status is to be clarified or if new rules and standards are to be adopted, these varied and conflicting concerns must be evaluated, and where possible, reconciled.

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B. Taxpayers-Payors

Taxpayers who pay others for providing services are required to determine whether their relationship with these workers is a common law employer-employee relationship, whether the workers are independent contractors, or whether the relationship is determined by a specific statutory classification. Because the taxpayers' responsibilities and liabilities vary according to the relationship, it is important that the classification be determined accurately. For the taxpayer, therefore, ease and certainty in making a correct classification are vital.

For some taxpayers, the difference in the tax burdens borne by employers and by persons who deal with independent contractors is so important that they will attempt to structure their relationships with workers to fit the requirements of the preferred classification. In some cases where adjustments to relationships' structures are possible, taxpayers have treated workers as independent contractors in order to avoid social security (FICA) and unemployment (FUTA) taxes and the administrative costs of withholding workers' Federal income taxes. Completing and filing information returns required under present law with respect to compensation paid to workers entails only administrative costs.

Generally, the cost of complying with information return reporting with respect to compensation payments is minor because all taxpayers, in any event, must maintain adequate records of all payments which potentially are subject to such reporting. These records must be maintained both to substantiate the payments for tax and accounting purposes generally, and to determine what cumulative annual payments have to be reported on information returns. Thus, the incremental compliance cost of completing and filing information returns ordinarily is low.

If the dollar amount of the payments which are subject to information reporting were to be reduced, *e.g.*, from $600 to $300, the overall compliance cost, of course, would increase. Similarly, compliance costs would rise if payors were required to furnish copies of information returns to recipients of payments covered by the returns. The additional cost involved in either situation would consist primarily of miscellaneous accounting and clerical fees incurred in sorting and aggregating payments made during the year, and in preparing and mailing the applicable forms to the IRS and to the payment recipients.

Some types of information reporting requirements may involve bookkeeping and administration significantly more difficult and expensive than the minimal recordkeeping presently required of many taxpayers, particularly those with small businesses, in connection with their compensation expenses. Therefore, the imposition of new recordkeeping or filing requirements must be evaluated carefully both for cost and complexity.

Without clearly established rules for the classification of workers as employees or as independent contractors, various businesses may be placed in an economically disadvantageous position vis-a-vis other similar operations. For example, assume that the *A* company and the *B* company are substantially similar enterprises, and that *A*'s workers are treated as independent contractors, while *B*'s workers (who perform functions identical to those of *A*'s workers) are treated as employees. (This difference in treatment could be explained either in terms of each business' interpretation of the common law test, or by virtue of a reclassification of workers by the Service pursuant to an audit.) In such an instance, the *B* company must withhold income taxes from its workers' compensation, and pay an employer's share of employment taxes. Moreover, *B* must comply with the various obligations pertaining to recording and depositing such funds, in addition to furnishing each employee with an annual statement as to that employee's taxes. On the other hand, the *A* company simply must record the amounts paid to its workers in such a manner that *A* can substantiate the payments for tax purposes generally, and determine whether the aggregate annual payments to any worker necessitates the filing of information returns. While *A*'s failure to satisfy the latter obligation could result in a $1 penalty per covered payment, *B*'s failure to comply with its obligations could result in substantial penalties. Thus, because of the significantly different obligations of each company, *A* might have a competitive advantage over *B*.

C. Individual Workers

For the individual workers, their status as employees or as independent contractors determines their liability for contributions, their eligibility for benefits under the social security program (FICA or SECA) and their eligibility for benefits under the unemployment compensation program (FUTA). Therefore, it is important that their proper treatment for employment tax purposes be determinable with certainty.

Because Federal income tax is withheld from employees' wages, preparation of their annual income tax returns and payment of any additional liability involves relatively little recordkeeping and paperwork, except for employees with significant income in addition to wages or with many or large itemized deductions. Independent contractors, as well as certain statutory employees (Code sec. 3401(a)(1)–(17)), generally bear greater recordkeeping burdens than employees. Independent contractors must file returns and pay income taxes quarterly on an estimated basis because their compensation is not subject to Federal income tax withholding.

Under present law, employees are liable for social security taxes (FICA) at lower rates than the rates applicable under the Self Employment Contributions Act to the earnings of independent contractors. (Employers, however, also are liable for FICA taxes with respect to each employee, and, in addition, are subject to an additional tax with respect to wages paid to employees under the Federal Unemployment Tax Act.) The earnings of independent contractors and statutory employees (except full-time life insurance salesmen and certain home workers) are not subject to the FUTA tax; but such individuals, are also ineligible for unemployment compensation.

D. Tax Administrators

For tax administrators, withholding of Federal income tax and the employee share of FICA taxes from compensation paid to individuals provides the most efficient and effective means of collection of tax liabilities. Because the withholding system centralizes in employers the responsibility for paying over taxes, the number of separate payments received each pay period by the Treasury is vastly reduced. The Treasury must process fewer separate items, making the collection process far less expensive than it would be if all individuals paid their taxes directly and separately.

Withholding Federal income taxes probably contributes significantly to the generally high rate of compliance with the Federal income tax laws. Wages which might be underreported either by design or inadvertence, if individuals had to report and pay taxes separately and directly, are more likely to be reported fully under a withholding system. Although the actual measure of greater compliance under a withholding system compared to a direct payment system is difficult to determine, the compliance benefits of a withholding system appear probable.

Withholding also may contribute to taxpayers' sense of fairness in the operation of the revenue laws. This sense is an essential factor in a voluntary payment system. The greater the likelihood that everyone's income is disclosed fully to the Government, the less reason there is for any feeling of inequity to develop and the less motivation—and opportunity—to conceal income.

The processing of quarterly estimated tax returns and estimated tax payments required of independent contractors and statutory employees entails the handling of many small returns, each involving comparatively small amounts of money. Administering such items may produce relatively little revenue in relation to the expense involved. However, if the Internal Revenue Service does not commit sufficient resources to its administration of these returns, taxpayers who are self-employed would be less likely to be subject to IRS scrutiny than employees and more likely would have their errors, intentional or inadvertent, overlooked.

Administration of the social security system, which is funded by FICA and SECA taxes, also involves less expense where social security taxes are withheld and paid over by employers than where paid individually by workers. The probability of greater compliance in a withholding system also exists with respect to social security taxes. However, the actual measure of any greater rate of present compliance with FICA, compared to SECA taxes, is unclear under present law.

CONTENTS

3

4

5

III. ALTERNATIVES

A. Present Law

Although payors, workers and administrators may differ on the relative importance of problems with the common law rules governing employment status, their concerns indicate two primary issues: certainty and compliance.

1. Uncertainty of classifications

The Internal Revenue Service generally relies on payors to make an initial determination as to whether their workers are employees or self-employed. Subsequently, the IRS may check on the validity of these determinations through its audit program.

With certain specific statutory exceptions, the Internal Revenue Code defines an employee as "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of employee" (Code sec. 3121(d)). Under the common law test, if a person engaging the services of another has "the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which the result is accomplished," the relationship of employer and employee generally is deemed to exist (Treas. Reg. § 31–3401(c)-1(b)). The determining factor under the common law test, thus, is the degree of control, or right of control, which the employer has over the worker. Therefore, little importance may be attached to the form of the relationship. Job contracts, separate bookkeeping, and separate business locations, for example, may be accorded little weight by the IRS in determining whether an individual is an employee or is self-employed.

Industry representatives and other affected parties have expressed concern over the use of the common law criteria for defining an "employee." Some industries with hard-to-classify occupations have sought Congressional relief from IRS positions that the relationship between workers and the persons paying the workers for their services is within the common law relationship of employer and employee. Many of these industries have pointed to widespread industry practices of treating certain workers as independent contractors, and have claimed that the common law definitions, as administered by the IRS, are unclear and inconsistently applied. Others contend that inequities occur because the common law may not allow independent contractor status for sales persons or distributors who sell their products. Some groups, on the other hand, have no objection to the common law test *per se*, but only dispute the way the common law is interpreted by the IRS.

In determining whether the necessary degree of control exists in order to find that an individual has common law employee status, the courts and the Internal Revenue Service ordinarily use a number of inferential factors. Because the basic issue of an individual's employment status is a factual matter, the use of these factors requires more than a mechanical comparison of the number of items which do, or do not, indicate the presence or absence of an employer-employee relation-

ship. Likewise, no single factor generally is dispositive of the issue. Instead, all of the facts of a particular situation must be evaluated and weighed in light of the presence or absence of the various pertinent characteristics. The decision as to the weight to be accorded to any single factor necessarily depends upon both the activity under consideration and the purpose underlying the use of that factor as an element of the classification decision. Because of the particular attributes of a specific occupation, any single factor may be inapplicable.

The twenty common law factors [1] used to determine whether an employer-employee relationship exists are directed at the following questions:

1. Is the individual providing services required to comply with instructions concerning when, where, and how the work is to be done?
2. Is the individual provided with training to enable him or her to perform a job in a particular manner or method?
3. Are the services performed by the individual integrated into the business' operations?
4. Must the services be rendered personally?
5. Does the business hire, supervise, or pay assistants to help the individual performing services under contract?
6. Is the relationship between the individual and the person for whom he or she performs services a continuing relationship?
7. Who sets the hours of work?
8. Is the individual required to devote full time to the person for whom he or she performs services?
9. Does the individual perform work on another's business premises?
10. Who directs the order or sequence in which the work must be done?
11. Are regular and/or written reports required?
12. What is the method of payment—hourly, weekly, commission, or by the job?
13. Are business and/or traveling expenses reimbursed?
14. Who furnishes tools and materials necessary for the provision of services?
15. Does the individual performing services have a significant investment in facilities used to perform services?
16. Can the individual providing services realize both a profit or loss?
17. Can the individual providing services work for a number of firms at the same time?
18. Does the individual make his or her services available to the general public?
19. Is the individual providing services subject to dismissal for reasons other than nonperformance of contract specifications?
20. Can the individual providing services terminate his or her relationship at any time without incurring a liability for failure to complete a job?

The application of the common law factors to specific work relationships often is open to broad and inconsistent interpretation because

[1] The twenty common law factors are set forth in the following Internal Revenue Service documents: Exhibit 4640–1, Internal Revenue Manual 8463 and Chapter 2, "Employer-Employee Relationships," Training 3142–01 (Rev. 5–71).

not all of the factors are present in every situation, some of the factors do not apply to certain occupations, and the factors vary as to applicability and importance in different situations. Even though the IRS may attempt to develop all of the relevant facts relating to a particular situation, evaluating the weight to be accorded the various factors often is a subjective matter. Thus, employers in some industries cannot determine, with any degree of certainty, who will be considered an employee until they obtain an IRS ruling or until the IRS has conducted an audit.

2. Noncompliance

GAO, IRS and Justice Department Surveys

Tax administrators have expressed concern about the increased possibility of noncompliance with the employment tax laws where income, particularly self-employment earnings, is not subject to withholding at its source. In preparing its report to the Joint Committee, the GAO conducted a statistical study of independent contractors reclassified by the Internal Revenue Service as employees, and found that such individuals paid up to 91 percent of the taxes owed by them on the remuneration received by them for their services. However, the GAO found that risks with respect to the Social Security Trust Fund may be more significant. On the basis of reviewing 126 audit case files of 82 persons, the GAO found that 16 percent did not report all their self-employment income and 13 percent of the self-employment income was not reported. GAO also analyzed the tax returns of 37 employees from 5 of the 92 case sampled. Of these 37 employees, just 24 (slightly under two-thirds) paid Social Security (SECA) tax on their income earned while considered self-employed. The GAO study was confined to closed cases involving abatements.

In an attempt to get a broader picture of compliance in this area, the IRS conducted a study of its own. The IRS study was based on a different sample of cases. It showed that independent contractors reclassified by the IRS as employees reported about 74 percent of the amounts received by them as remuneration for services.

The Internal Revenue Service believes that, even on the basis of the GAO study alone, the risks of noncompliance, particularly with respect to the Social Security Trust Fund, are substantial. However, the Internal Revenue Service is not confident of the results reported in its sample. Therefore, the Service currently is making another effort to obtain better data about compliance.[2]

The Department of Justice [3] believes that because independent contractors are not subject to withholding there is substantial nonreporting of self-employment income. On the basis of its experience over the years and a survey of its trial attorneys, the Department of Justice believes that in many cases 50 percent or less of such income is reported on income tax returns.

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[2] Letter of Jerome Kurtz, Commissioner of Internal Revenue, to Bernard M. Shapiro, Chief of Staff, Joint Committee on Taxation, January 15, 1979.

[3] Letter from Kevin D. Rooney, Assistant Attorney General for Administration, United States Department of Justice, to Victor L. Lowe, Director—General Government Division, United States General Accounting Office, Report of the Comptroller General to the Joint Committee on Taxation, "Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions," GGD–77–88, November 21, 1977, p. 87.

The Department of Justice also believes that the problem of reporting with respect to self-employment taxes is greater than with respect to reporting for income taxes generally. Even those who report the compensation as income often fail to file the requisite Schedule C (Profit or Loss from Business or Profession) and Schedule SE (Computation of Social Security Self-Employment Tax). In addition, the fact that income may be subject to SECA but not subject to income tax contributes to underreporting for SECA purposes. The self-employment tax is imposed on earnings from self-employment of $400 or more per year. However, individuals having such earnings may owe no income taxes and may not be required to file an income tax return. Therefore, individuals in this situation may not file the required self-employment tax return. In such cases, individuals who are not treated as employees may not, overall, make the same contribution to the social security system as others similarly situated, who are treated as employees.

The Department of Justice believes that the substantial difference in cost to the businessman in having workers classified as self-employed rather than as employees contributes to conflicts over status classifications. The employer share of FICA taxes and the FUTA tax constitute additional expenses not borne by persons who deal with independent contractors.

Effect on Social Security System

The treatment of workers as self-employed individuals rather than as employees can have various effects on the social security system under present law depending upon the particular facts and circumstances involved in any given situation.

If a worker reports his or her earnings as self-employment income, the worker will receive credit for the earnings for social security benefit purposes. In this situation, the self-employment taxes paid into the general fund are credited to the social security trust funds.

If a worker reports his or her earnings as self-employment income but does not pay self-employment tax with respect to those earnings, he or she still receives credit for the earnings for social security benefit purposes. In this situation, the Social Security Trust Fund is credited for the amount of employment taxes due on the earnings and the general fund loses the amount of the unpaid taxes.

If a worker fails to report his or her earnings and fails to pay self-employment taxes, he or she will not receive credit for earnings for social security benefit purposes. However, self-employment income can be credited to the social security earnings record for benefit purposes if the earnings for a year are reported to the Internal Revenue Service within three years, three months, and 15 days from the close of the year. Self-employment income for a year reported after that time limit cannot be credited for social security benefit purposes.

Finally, if a self-employed individual is reclassified by the IRS as an employee, the wages paid the employee are credited for social security benefit purposes. The employer's and employee's share of the social security taxes due on the wages is assessed against the employer by the IRS. In this situation, the wages are credited and amounts equivalent to the employer-employee taxes are credited to the trust funds whether or not the taxes are collected.

B. GAO Recommendations

1. Analysis of GAO criteria

The GAO concluded that a majority of the employee/self-employed controversies involve situations where workers operate a business separate from the one which the Internal Revenue Service considers to be the employer.[1] These situations may include those in which individuals: (1) provide, and are paid for, an end product, such as blueprints; (2) sell a supplier's product at a markup over cost; (3) install, under contract or subcontract, a product such as carpeting or air-conditioning which is sold by another business: (4) subcontract work from a prime contractor; or (5) sell, through an independent agency, another party's product, such as insurance, on a commission basis. The GAO does not believe that all such relationships should be considered as one of employer-employee, but rather that some of these should be excluded from the common law definition.

To simplify status determinations for the problem situations which it identified, the GAO outlined a general statutory approach which might serve as a model for a legislative solution. The GAO has recommended that separate business entities should be excluded from the common law definition of employee. The GAO believes that its legislative proposal would eliminate many of the hardships, inequities, and instances of general confusion in the employment tax area. Under the GAO proposal, the owner of a separate business entity would be excluded from the common law definition employee if he or she:

(1) has a separate set of books and records which reflect items of income and expenses of the trade or business;

(2) has the risk of suffering a loss and opportunity of making a profit;

(3) has a principal place of business other than at a place of business furnished by the persons for whom he or she performs or furnishes services; and

(4) holds himself or herself out in his or her own name as self-employed and/or makes his or her own services generally available to the public.

Under the GAO proposal, an employer-employee relationship would exist if an individual met fewer than three of the above criteria. If an individual met three of the four criteria, the common law criteria would be used to determine employment status. The GAO further recommended that, absent fraud, the Internal Revenue Service should be prevented from making a retroactive employee determination if the business annually obtains from the workers it classifies as a self-employed signed certificates stating that they meet the sepa-

[1] Report of the Comptroller General to the Joint Committee on Taxation, "Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: "Problems and Solutions," GGD–77–88, November 21, 1977, p. 19.

rate business entity criteria and the business annually provides the IRS with the names and employer identification or social security numbers of all certificate signers.

In many cases, the GAO criteria would simplify the determination of whether an individual is an employee or a self-employed person because an initial determination would be based upon four factors rather than 20 factors. For some individuals it would never be necessary to resort to the common law test. For example, if an individual met all four factors, he or she automatically would be classified as self-employed. On the other hand, if an individual met only two or fewer factors, he or she automatically would be classified as an employee. Only where an individual met three of the four factors would it be necessary to resort to the common law. Thus, to the extent that resort to the common law is lessened, the GAO proposal could lead to greater certainty and simplicity. However, for an individual who must be tested under the common law, some observers have suggested, an additional, preliminary layer of complexity would be added (that is, he or she first must meet three of the four GAO criteria).

While the approach and effects of the GAO proposal have been generally well received, it has been noted that the GAO criteria might create some new problems. However, many of these problems could be eliminated or minimized by perfecting legislative amendments. For example, taxpayers might try to meet the specified criteria by changing the form of their work relationships without changing the substance of these relationships. In effect, the GAO proposal might allow many workers to elect independent contractor status merely by reordering their affairs. Permitting a large number of workers to elect to be treated as independent contractors might have an adverse effect on the general level of income tax compliance and might reduce participation in both the Federal unemployment insurance system and the social security system.

The four proposed GAO criteria might entail some other uncertainties and difficulties. For example, the GAO recommendation that section 3121 of the Internal Revenue Code be amended to exclude separate businesses from the common law definition of employee where they have a separate set of books and records, which reflect items of income and expense, may create additional problems. A definition of what constitutes "a separate set of books and records" which adequately reflects items of income and expense would be required. For example, in commenting upon the GAO report, the Justice Department apparently considered the criterion that self-employed persons should maintain separate books and records to be meaningless.[2] The Justice Department apparently reasoned that a simple checkbook could satisfy this requirement. However, the GAO report noted that the separate books and records requirement should involve more than either a checkbook, or "scrap pieces of paper." Nevertheless, the appropriate parameters of what should constitute a "separate set of books and records reflecting items of income and expense" need to be decided and delineated. In many cases, a checkbook restricted to business use may provide an adequate record of a business' expenses. If income items are deposited exclusively into a checking account, such an account could provide an adequate record of items of the taxpayer's in-

[2] GAO report, p. 43.

come. On the other hand, in most cases a single checkbook will be inadequate to provide a "set of books and records" which comprehensively reflects a business' items of income and expense.

Depending upon the nature of the activities involved, a taxpayer may be required to maintain a number of accounts, other than checking accounts, under various regulatory statutes. Where such accounts are required to be established and maintained under local law in order to conduct a business, the absence of such accounts generally could indicate a status of other than an independent contractor. However, it merely may indicate that a taxpayer who, in fact, is an independent contractor, simply has failed to comply with local regulatory statutes. Conversely, it could indicate that such a person actually was an employee under the common law definition.

Similarly, the present form of the GAO recommendation that an individual be subject both to a profit opportunity and to a risk of loss, in order to meet the independent contractor test, could create definitional problems as to what items should be taken into account in determining whether such an opportunity or risk exists. Disputes could arise as to the appropriate treatment of fringe benefit expenses. For example, the GAO would exclude from the definition of profit or loss bona fide business conference and educational expenses,[3] even though such expenses generally are categorized as ordinary and necessary business expenses under section 162 of the Code. In developing the profit and loss test, the GAO has suggested a standard, widely recognized as relevant, but which will require greater specificity if it is incorporated in legislation.

The GAO's principal place of business criterion also could foster definitional and administrative problems. Many taxpayers may not have a "principal place of business" because of the particular nature of their profit seeking activities. Other taxpayers would not qualify as having a principal place of business under the present income tax rules with respect to the use of a residence as a place from which the taxpayer operates, but which otherwise is not used exclusively by that taxpayer as his or her principal place of business (sec. 280A(c)(1)). With respect to these individuals, the GAO principal place of business criterion might continue the confusion and uncertainty of the common law employee classification test. Since these individuals could not satisfy the GAO "safe harbor" test, their classification as an employee or an independent contractor would continue to be governed by the common law factors (unless they also failed to satisfy one of the remaining three GAO factors, in which case they automatically would be categorized as employees).

The proposed certification procedure would relieve some persons who pay others for services from the threat of retroactive employment tax assessments by the IRS. However, this proposal might hinder the audit process, which is a basic tool of tax enforcement, because audits by definition are retroactive. Limited IRS audit resources probably would not allow the vertification of a meaningful number of certificates and, therefore, the proposal could lead to widespread abuse. For example, unfair arangements could arise as a result of the general disparity of economic bargaining positions of the parties. Generally, businesses command a more advantageous economic position than

[3] GAO report, p. 21.

those parties who seek to work for, or become associated with, the business. As a result, a business could require, at least theoretically, that all potential workers execute an "independent contractor certificate" prior to, and as a condition of, the establishment of a working relationship with the business, regardless of either the reality of the situation, or how those parties might be classified under the common law criteria. This could be an acute problem in times of high unemployment, and in those instances where an indivdual may not be expected to understand fully the implications of signing such a certificate.

Conversely, it can be argued that businesses normally do not engage in overbearing practices, and that they are unlikely to begin such practices merely to save tax dollars that would be payable if an individual is an employee rather than an independent contractor. Businesses might be more likely to use an "independent contractor certificate" to provide some certainty in their tax obligations.

In an attempt to assure that an "independent contractor certificate" is an uncoerced indicator of an individual's employment status, the GAO recommendation could be modified to require that such a certificate be executed both by the individual worker and by a representative of the business. The certificate could be signed under affirmation by the business that the individual reasonably would be classified as an independent contractor under the common law criteria, as interpreted by the business under the applicable facts and circumstances, and that no coercion was used in obtaining the individual's signature. Similarly, individuals could be required to execute a certificate to the effect that (a) they reasonably believe themselves to be independent contractors, (b) they satisfy the factual requirements to be an independent contractor, (c) they understand the implications of the classification, including the tax consequences, and (d) no coercive influence was placed on them to execute the certificate. Violation of these affirmation requirements could be made subject to a penalty.

Nevertheless, some critics have contended that the execution of an "independent contractor certificate" may not prove helpful, either for the parties involved, or for the appropriate classification of an individual as an employee or as an independent contractor.[4] Requiring signed affirmations on a Form W–4 on which an individual indicates the applicable number of withholding exemptions as a general "independent contractor certificate" is unlikely to have the same impact on the individual unless such a certificate appropriately indicates its future income and employment tax ramifications.

Possible problems with the GAO criteria do not necessarily invalidate this approach to the employee/independent contractor controversy; they merely indicate that some modifications and more specific and detailed legislative guidance may be desirable.

2. Comments received on GAO report

Upon release of the GAO report on the tax treatment of employees and self-employed persons, the Joint Committee on Taxation invited

[4] Both the courts and the Service have recognized that a contractual provision which specifies that an individual is an independent contractor will not be considered to be dispositive of the issue if the facts and circumstances indicate that the individual is an employee. See *Bartels* v. *Birmingham*, 332 U.S. 126 (1947); Rev. Rul. 74–98, 1974–1 C.B. 292, 293. (The passage of the "Gearhart" Resolution, H.J. Res. 296, Pub. L. 80–642, 80th Cong., 21 Sess. (1948), was not intended to alter this aspect of the *Bartels* decision. See S. Rep. No. 1255, 80th Cong., 2d Sess. (1948); *Crossett Lumber Co.* v. *U.S.*, 79 F. Supp. 20, 25 (W.D. Ark. 1948).)

written comments from the public on the GAO's findings, conclusions, and recommendations. The staff of the Joint Committee received approximately 50 formal, written responses from various interested persons and groups. These comments were reviewed in connection with the staff's study of the employment tax controversy. These comments generally concerned the retroactivity of employment tax determinations and suggestions for future standards to be used in making such determinations.

General

While the comments on the GAO report covered a broad range of proposals, from retaining the common law standards to eliminating them and from supporting the GAO proposals to suggesting entirely different criteria, common themes ran through most of the comments. The majority of groups which commented on the report, while proposing different solutions, felt that there are two major problems with employment tax status determinations by the Internal Revenue Service. One problem is the retroactive nature of employment tax status determinations and the other is the double collection of taxes which often results when an "independent contractor" is reclassified by the Service as an employee. Most urged that whatever shape proposed legislation ultimately takes, it should address these two problem areas.

Retroactive assessments

At least 26 groups voiced opposition to the retroactive assessment of employment taxes under present law. Most of these groups felt that retroactive assessments should be allowed only in cases involving bad faith, fraud, or negligence. Furthermore, some of these groups felt that if retroactive assessments were to continue to be allowed that there should be some mechanism to prevent the double collection of employment taxes (*i.e.*, once at the employer level as taxes the employer initially failed to collect and once at the employee level as taxes previously paid). Five groups endorsed the GAO proposal to prevent retroactive assessment of employment taxes in cases where workers have been certified as self-employed.

Future standards

The comments on future standards for employment tax status determinations varied. At least nine groups supported the retention of some of the common law rules. Of these groups, six favored retention of the present law common law factors in the case of prospective employment tax status determinations. Of the three remaining groups, one group supported retention of the present common law standards in tandem with the GAO proposal; another group would assign weights to the various common law factors; and another would continue the use of the common law rules but create "safe harbors" and grant the Tax Court jurisdiction over employment tax status determinations.

At least eight groups favored some form of the GAO approach for prospective employment tax status determinations. Three of these groups indicated their unqualified support for the GAO standards. One group favored using the GAO standards as a "safe harbor," and would allow only prospective reclassifications of employment tax status in all cases where there had been a good faith certification that the GAO standards would be met. Another group favored the GAO approach along with retention of the common law standards, while

another group favored the GAO approach but would expand it from a four-factor test to a ten-factor test.

At least three groups felt that employers should be permitted to certify that their workers are either employees or self-employed individuals. One group felt that such certification should be done on a quarterly basis. Another group felt that a certification procedure should be provided in conjunction with the present law common law standards.

At least four groups supported a proposal that contains some of the elements in the GAO proposal, as well as in the common law. Under this proposal, a worker would be classified as self-employed if the following five standards were met:

(1) The parties ("employer" and worker) agreed to independent contractor status;

(2) All income of the worker was commission income;

(3) The worker was not required to work any set number of hours;

(4) The worker had his or her own principal place of business or paid rent to the "employer"; and

(5) The worker had an opportunity for profit.

Also, under this proposal, the double collection of employment taxes would not be allowed.

Another group proposed a different five-part test for prospective employment tax status determinations. Under that proposal, a worker would be classified as self-employed if:

(1) The worker received only commission income;

(2) The "employer" could exercise no control over the worker as to work day, work location, customer lists, or selling procedures;

(3) The worker was not required to receive the "employer's" permission in order to sell to competitors of the "employer";

(4) The worker made insubstantial use of the facilities of the "employer"; and

(5) The worker did not hold himself or herself out as an employee of the "employer".

One group proposed two requirements for self-employed status. First, a worker's compensation would be required to be solely in the form of commissions. And, second, the worker and the person engaging his or her services would be required to enter into periodic written agreements which would obligate both parties to conform to the requirement that compensation be received only in the form of commissions. Neither party to the relationship would be permitted to take a position before the Internal Revenue Service that was inconsistent with the written agreement.

At least five groups favored granting the Tax Court declaratory judgment jurisdiction over employment tax status determinations.

While one group felt that self-employed individuals should be subject to the same withholding requirements as employees, another group said that the question of withholding should be entirely separate and apart from the question of employment status. There were suggestions that the parties should be allowed to elect their employment status, that information returns be required with respect to all workers, and that the Internal Revenue Service establish industry guidelines for determining the employment status of workers.

C. Information Reporting

One modification of present law which could be implemented to accommodate both the legitimate interests of taxpayers and of the government, without changing the common law test for the determination of employment status, might be to expand the category of payments for services which are subject to information reporting. This could be done in two ways: expanding the types of payments subject to reporting or lowering the minimum dollar amount for which information returns are necessary.

1. Expanded definition

The definition of what payments are subject to information reporting could be clarified and expanded. For example, the term "payment", as used in section 6041(a) of the Code, could be modified so as to include explicitly all disbursements (above a threshold amount) for services and situations involving the purchase of discounted resale merchandise where the discount consistently reflects an ascertainable percentage of the resale price. In the latter case, the amount to be reported would be the difference between the discounted price and the generally prevailing resale price. The ultimate vendor of the merchandise, of course, would be free to establish, on his or her income tax return, that the price differential was not an adequate reflection of taxable income.

This expanded obligation could be restricted to payment situations which involve a full-time and continuing service relationship between the payor and the worker, where the latter independently bears few expenses or risks of the enterprise. Alternatively, such an expanded information reporting requirement could be extended to all ongoing payor-payee service relationships, regardless of whether the payee would be classified as an employee under the common law control test. The latter approach could be applied either with respect to substantially full-time service relationships, or both to those situations and to similar part-time relationships. Regardless of which approach were adopted, generally the only exception to the expanded reporting requirements would be instances in which computing the amount to be reported would be administratively or technically infeasible, for example, situations in which merchandise for resale is purchased at a discount (and the discounted sales price does not reflect an ascertainable percentage or amount of the resale price).

2. Lower minimum payment

A second method of increasing the number of payments which are subject to information reporting would be to reduce the dollar amount for which such returns are necessary. Currently, information returns are required of persons engaged in a trade or business with respect to certain payments of $600 or more during the course of any taxable

year. (See discussion of Information Returns, I.A.3., p. 5.) For example, business taxpayers could be required to file information returns for aggregate annual payments of $200, instead of $600, or more during the year to any individual.

This change, which would not affect employment status, might aid the Internal Revenue Service in the implementation of its enforcement responsibilities, and increase the parties' awareness of their respective income and employment tax reporting and compliance obligations.

3. Other changes

Regardless of whether any changes are adopted in the withholding system, an expansion of information reporting might be supplemented by two general changes in present law. First, payors might be required to furnish payees with copies of returns which potentially relate to their tax liability. This modification of present law might facilitate the filing of accurate returns by payees by providing them with a timely record of payments received during the year. Since payors, in any event, would have to maintain records sufficient to prepare and file the information returns, the additional burden of supplying payees with a copy of the returns would appear minor for most payors.

Another general change which might accompany an expansion of information reporting is an increase in the penalty for failure to file, and the provision of a similar penalty for failure to furnish payees with a copy of the relevant returns. Under present law, a one dollar ($1.00) penalty is provided for each failure to file an information return (Code sec. 6652(b)), with a $1,000 maximum aggregate penalty for all such failures during any calendar year. The present law penalty is inapplicable if the failure to file is due to reasonable cause, and not to willful neglect. There is no comparable penalty for failure to provide copies of these information returns to payees. An increase in the failure to file penalty, and the provision of a similar penalty for failure to furnish payees with a copy of the relevant returns, might induce a higher level of compliance.

4. Evaluation

An expansion of information reporting, regardless of whether it is combined with a minimum income tax withholding requirement, would not address issues relating to any individual's employment status. As a result, the potential for ambiguity and controversy which exists under the present law would not be eliminated. Nevertheless, changes in information reporting and the related penalties could increase the Service's ability to administer the tax laws and to ascertain each party's compliance with the applicable income and employment taxes. If the Service matches information returns with individual income tax returns, these changes could lead to an increased overall compliance rate. The Service's ability to match information returns with regular individual tax returns could be facilitated, for example, by the adoption of a special Form 1099 which would be used only for cumulative annual service payments in excess of a threshold amount.

Expanded information reporting may not result in a significant increase in tax administrative costs for the payors involved. Since these taxpayers currently must comply with information return obligations for compensation payments of $600 or more, any additional administrative costs involved in an expanded information reporting requirement would relate to completing the appropriate form and to furnishing payees with copies. Records relating to such amounts which are disbursed during the year must be maintained in any event, as part of the ordinary conduct of the payor's trade or business, both for accounting and financial purposes, and in order to be able to comply with tax obligations generally.

For payees, expanded information reporting would not increase, but rather would be likely to reduce, administrative or compliance costs.

D. Withholding

One alternative to the continued use of the common law test would be to expand income tax and social security tax withholding requirements.

1. Income tax

Concerns about noncompliance with the Federal income tax might be alleviated if payors of amounts which are compensatory in nature were required to withhold taxes due with respect to those amounts which are paid for services. Such an expanded obligation could be restricted to payment situations which involve a full-time and continuing service relationship between the payor and the worker, and where the latter independently bears few expenses or risks of the enterprise. Alternatively, such expanded withholding could be extended to all ongoing payor-payee service relationships, whether or not the payee would be classified as an employee under the common law control test. The latter approach could be applied only with respect to substantially full-time service relationships, or both to those situations and to similar part-time relationships.

Special exceptions or modifications would be required for income tax withholding on the earnings of self-employed individuals. The compensation paid to independent contractors often does not reflect their net earnings, that is, the amount of income subject to tax after accounting for deductible business expenses. Ordinarily, the payor has no way of knowing the payee's net income. Thus, there is a potential for significant overwithholding if income tax is withheld from compensation paid to independent contractors. Withholding might be set at a *de minimis* rate, for example, one percent of payments, to an independent contractor. Such token withholding might improve compliance because some independent contractors, who are non-filers and who might avoid the tax system and never be examined, would be brought into the system. However, it is doubtful whether the additional tax revenues obtained from non-filers would justify the administrative complexity and expense which withholding on self-employment earnings would entail. Additional exceptions to the expanded withholding requirement would be necessary for situations where computing the amount to be withheld would be administratively or technically infeasible, for example, situations in which merchandise for resale is purchased at a discount (except where the discounted sales price consistently reflects an ascertainable percentage or amount of the resale price).

A general rule might provide that the payors must withhold Federal income tax from compensation paid to any persons who perform services for the payors. Only the income of those workers who qualify under exceptions to the general rule would be exempt from withholding. Exceptions might be drafted with objective tests in order to reduce uncertainty and taxpayer-IRS disputes. For example, one

exception to a generally applicable withholding rule might cover workers who perform services for the payor for fewer than a specific, limited number of days during a year. Similarly, workers who invest a substantial amount of their own funds in the conduct of the trade or business might be excepted. A minimum basis figure or a minimum rental expense for an investment exception might be established at a specific dollar amount. Specificity in defining any exceptions would increase certainty, although it necessarily entails some arbitrariness.

If an expanded withholding rule is added to the present rules based on the common law, it might facilitate certainty for cases which are unclear under the common law. However, it would require extra analysis for taxpayers whose workers are not clearly common law employees, but whose relationship would have to be evaluated under these new tests. Similarly, if withholding were required on compensation paid to any worker who rendered more than a specified number of days of service to the payor, the administrative burden would be increased.

As is the case under present law with respect to withholding, an individual's tax liability for any year could exceed, or be less than, the amount withheld. In such an instance, the appropriate adjustment, as established by the taxpayer, would have to be made.

2. Social security taxes

An expansion of income tax withholding obligations to payors of compensatory amounts for services under ongoing relationships would not necessarily resolve questions about a worker's status and the resulting liabilities for FICA or SECA and for FUTA taxes. Although withholding and paying over of SECA taxes could be required in addition to income tax and FICA obligations, questions about workers' proper status still would arise. Extending withholding requirements alone, without making the applicabilty of withholding also the determinant of an employment relationship, would not eliminate the question of whether the payee was an employee or a self-employed person for employment tax purposes. As a result, the amount to be withheld would be uncertain in many cases.

One way of attempting to minimize these ambiguities might be to require payors, who were made subject to an expanded income tax withholding obligation, to withhold from the worker and to pay over an amount no larger than an employee's share of employment taxes. (Such action would give no inference as to the payee's proper classification for purposes of the employment tax obligations of either party.) If the amount withheld were less than the SECA taxes due on the same amount of income, the worker would have to pay this amount in any event. However, if the worker is a self-employed person, his or her compensation paid may exceed his or her net earnings, that is, taxable SECA income.

3. Evaluation

If there were a significant expansion of withholding obligations, the rate of tax compliance among those categories of persons which previously were not subject to withholding might be expected to increase somewhat over present levels, both as to income and employment taxes. To the extent that the reporting of self-employment income would improve under an expanded withholding system, there would be

increased revenues to the social security trust funds, and increased social security protection for the workers involved. At the same time, the Government's administrative costs relating to compliance with, and enforcement of, the tax laws might be reduced. In addition, it is unlikely that any increased audit activity would be required to obtain either an increased compliance level or a reduction in Government costs.

Although expanded income and employment tax withholding might increase compliance levels and reduce general enforcement costs, it also is likely to result in increased tax administrative costs for some payors, *i.e.*, those parties who currently are not subject to withholding responsibilities. Because these taxpayers presently must comply with information return obligations for certain payments of $600 or more (see discussion of Information Returns I.A.3., (p. 5), any additional administrative costs involved in an expanded withholding requirement would relate to computing and paying over the amounts withheld on a continuing basis, and to furnishing annual statements to payees. In some cases, these costs could be substantial even though they generally would be deductible for income tax purposes.

An expansion of income and employment tax withholding generally would not increase administrative or compliance costs for payees. Since most additional requirements would be imposed on payors, the costs borne by payees actually might decrease in comparison with those borne under present law. At present, evidence is insufficient for evaluating whether the benefits from expanded withholding justify its costs and shifts in the present law responsibilities.

Expanded withholding would not end the problems of uncertainty about the definitions of "employee" and "independent contractor." And, these problems would continue to affect payors of workers in many job categories unless the differences in the rates and imposition of the liabilities for SECA and FICA taxes, as well as the employment rule for FUTA taxes, were eliminated.

E. Statutory Classes of Self-Employed Individuals

A possible alternative to the use of the common law tests for determining whether an employer-employee relationship exists would be to expand the number of classes of individuals designated by statute as self-employed. This was the approach taken by the Congress in the Tax Reform Act of 1976 to solve the controversy involving whether certain crewmen of fishing boats were employees or independent contractors. There currently are twenty types of service that are exempted from the definition of employment for employment tax purposes (Code sec. 3121(b)).[1] A number of these types of services also are exempted from the Federal income tax withholding requirements (Code sec. 3401(a)). For some industries, statutory specification involves establishment of an arbitrary standard, for example, a maximum number of workers may be allowed, as in those provisions relating to certain work on fishing boats (Code sec. 3121(b)(20)).

As an alternative to expanding the number of types of services exempt from both employment taxes and Federal income tax withholding, certain types of service could be exempted from employment taxes but not from Federal income tax withholding. Or, an expansion of the types of services exempted from employment taxes could be coordinated with an expanded withholding system. (See discussion of Withholding, III. D., p. 38.) In addition, such an expansion could be coordinated with an expanded information reporting requirement. (See discussion of Information Reporting III. C., p. 35.)

Expanding the number of classes of statutory self-employed individuals would provide greater certainty for taxpayers making payments for those types of services. Similarly, classifying the performance of such services as self-employment and subjecting the net earnings to self-employment tax, would provide certainty for the individuals who perform such services. However, for those individuals who currently are treated as employees, change to self-employment status might cause uncertainty and be perceived as complex, at least in the short run. In addition, uncertainty would exist for groups of workers who were not squarely within a definition.

A significant increase in the number of workers statutorily classified as self-employed would not be expected to increase the rate of tax compliance. However, if an increase in the types of workers classified as self-employed was coupled with an expanded withholding requirement, compliance might increase somewhat over current levels. The cost of, and time devoted to, enforcement of compliance with the self-employment tax might be expected to increase because of the

[1] Among the types of service excluded by sec. 3121(b) are services performed as an employee of the United States (or any instrumentality thereof) if such service is covered by a retirement system established by a law of the United States. It also excludes services performed by a duly ordained, commissioned, or licensed minister of a church in the exercise of his or her ministry.

larger number of tax returns that would have to be examined to obtain the same audit coverage provided under the present system.

An expansion of the number of workers statutorily classified as self-employed might have a negative impact on Social Security Trust Fund receipts. If the rate of self-employment tax were not increased to a rate equal to the combined employer-employee rate, the contribution to the trust fund on behalf of each worker would be decreased even if the worker has no deductible trade or business expenses to decrease his or her gross receipts from the performance of services.

To expand the number of classes of self-employed individuals would require the Congress to analyze groups of workers on an industry-by-industry, or category-by-category, basis. Such analysis would be very time consuming because of the significant number of different types of workers and relationships within various industries.

Dealing with classifications of worker groups on an industry-by-industry basis could subject the Congress to political pressure from many interest groups. In addition, such an approach could lead to similarly-situated workers within different industries being treated differently. Depending upon how narrowly or broadly the criteria for treatment as self-employed were drawn, workers within the same industry could receive disparate treatment.

F. Administration Proposal

The Administration's budget message for fiscal year 1980 [1] stated that the Administration will propose legislation to become effective for taxable years beginning after December 31, 1979, to clarify the distinction between an independent contractor and an employee.

[1] Budget of the United States Government, Fiscal Year 1980, p. 71–72.

IV. RELATED ISSUES

A. Federal Income Tax

Controversies over the proper classification of individuals as employees or independent contractors have focused on the Federal income tax withholding, social security tax and unemployment compensation tax liabilities of taxpayers who pay workers for services. Although these have been the principal issues and generally involve the greatest potential liabilities in such controversies, the classification of workers has additional ramifications.

The reclassifications of workers as employees may affect company and individual retirement plans. Taxpayers reclassified as employers may find that their employee pension plans are disqualified because employees, whom the taxpayers treated as independent contractors, were excluded from the plans. Similarly, workers, who considered themselves independent contractors, no longer may be entitled to maintain Keogh plans established for their own retirement and may have prior contribution deductions disallowed. Only workers who qualify as self-employed may claim certain expenses as "above-the-line" business expense deductions in determining their adjusted gross income.

In addition, the taxation of certain fringe benefits may depend on the workers' employment status. Employees may exclude from their income contributions paid by employers for the employees to, and any benefits received under, accident and health plans, qualified group legal services plans, employer educational assistance plans, and certain employer-provided life insurance and death benefit programs. The income tax exclusion and exemption enjoyed by some employee benefit programs, for example, under group legal services plans and educational assistance plans, may be lost if workers, who were treated as independent contractors, are found to be employees who should have been covered by the plans.

Thus, the settlement of both particular employment status cases and any substantive legislative changes in the classification standards must be accompanied by rules and procedures for unraveling associated pension, fringe benefit and other problems arising from these changes.

B. Social Security Taxes

The determination of the employment status of workers affects not only the question of employment tax liability, but also the total amount of liability with respect to each worker. If the Department of Justice is correct about the apparently lower compliance with the self-employment tax (SECA), the total amount of taxes collected could be expected to decrease, if there were an increase in the number of self-employed workers with a corresponding decrease in the number of employees. (See III, A.2., Noncompliance, p. 27.) Thus, changes in the law governing status classifications may have a substantial economic impact on the social security system and may raise questions with respect to who should bear the burden of supporting the system, and what measures might be necessary to prevent underfunding or insolvency of the Social Security Trust Fund.

The controversies over status classifications also have drawn attention to the issues involving the relationship between FICA and SECA contributions and benefits. Under present law, for purposes of determining an individual's social security benefits, the individual must establish that he or she worked as an employee and the amount of wages that he or she received. Payment of FICA tax—the employer's share and the withheld employee share—is not a requirement for employee coverage under the Act. Under these rules, employees are protected from employers who might withhold but fail to pay over the FICA tax. Even if the tax is unpaid, the employee is entitled to benefits on the basis of earnings. For purposes of determining a self-employed individual's benefits, earnings credit for self-employment income is permitted even though the SECA tax has not been paid, provided that the worker has filed a timely self-employment tax return. To the extent that employers misclassify employees as independent contractors, the social security system will be liable for benefits to employees with respect to whose wages no contributions were paid. Because self-employed individuals are responsible for paying their social security taxes directly to the Treasury, there appears to be less reason for the rules divorcing their benefits from contributions.

Changes in the law defining employment status classifications could affect the social security system significantly. If changes in status rules would tend to increase the number of individuals classified as self-employed, a group whose earnings are subject to a lower total rate of tax than employees' wages (and who also may pay less of their employment tax liability than employees), then some connection between the payment of SECA tax contributions and social security benefits for self-employed individuals at least might be appropriate. However, if changes in the status rules tend to increase the number of individuals whose earnings are subject either to FICA tax or to any revised social security taxes which are withheld from income at its source, the need to trace contributions in determining benefits declines.

C. Other Laws

The classification of workers as employees or as independent contractors for purposes of Federal employment taxes frequently affects their treatment under other laws. Many State income tax statutes parallel Federal tax law in this respect. Thus, State income tax withholding usually coincides with Federal withholding rules. In addition, the applicability of certain exclusions and deductions under State law may depend, as some do under Federal law, upon the workers' employment status. In order to claim business expenses as "above the line" deductions from gross income in determining Federal income tax liability, a worker usually must be self-employed. The same rule generally prevails in State systems as well, and the status classification standards ordinarily are the same.

An individual generally is eligible for unemployment compensation only if he or she worked as an employee. Thus, benefits paid through State systems depend upon whether workers were treated as employees and whether Federal Unemployment Tax Act taxes were paid with respect to their wages. Independent contractors cannot obtain unemployment compensation.

The classification of workers for purposes of Federal employment taxes also may affect whether and how other types of laws pertaining to employment apply to workers and the persons who pay for their services. The Federal minimum wage applies to employees but not to independent contractors. State minimum wage laws are similar. Some taxpayers have reported that after the Internal Revenue Service reclassified workers as employees, some State wage and hour law administrators also investigated their operations and alleged violations for periods during which they had considered their workers to be independent contractors to whom the wage and hour laws were inapplicable.

The reclassification of workers of businesses in which some were treated previously as employees and others as independent contractors also may alter the proper determination of bargaining units under labor relations laws. Laws safeguarding work places, establishing standards for working conditions, and providing protection from discrimination in hiring, promotion and benefits also may apply only to employees. The interpretation and administration of employment classifications by the Internal Revenue Service may be followed by officials in these areas as well as for use in their own investigations and enforcement. Thus, even though a Federal employment tax status reclassification is not binding for purposes of other laws, and even though it merely may signal to administrators that the application of other laws also may be at issue, changes in Federal employment tax status laws may have effects beyond the ordinary purview of tax administration. In the event of any Federal employment tax status changes, these effects must be evaluated and, if necessary, remedied.